The Effect of Flexible Ownership Regulations on Foreign Investments in the UAE: An Impact Evaluation Study Using a Quasi-experimental Method

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Abstract

Entrepreneurship can support economic growth and create jobs. Regulatory and policy restrictions on entrepreneurs starting new business are widely considered an impediment to entrepreneurial activity. The United Arab Emirates has recently deregulated the ownership rules for more than 1,000 commercial and industrial activities allowing full ownership of commercial companies in UAE (without requiring a partnership with a national sponsor). Before the introduction of these amendments, foreign ownership is not permitted to exceed 49% of the total assets of a company outside the free zones with the majority stake being held by an Emirati partner. This study represents the first attempt to assess the short-term impact of the liberalization of business ownership rules on the number of newly registered firms in the UAE. The study collects unique data that covers all types of business activity in Dubai. Monthly data on the number of new issued business licenses in Dubai has been used. We develop a difference-in-difference model with a treatment and a control group using panel data regression models. Our finding suggest that the liberalization of the ownership rules have led to a significant increase in the number of new business licenses on the sectors that were impacted by the liberalization policy by more than 170%. This early evidence may suggest relaxing the restrictions on business ownership may stimulate the entrepreneurial activity and economic growth in the Gulf region.

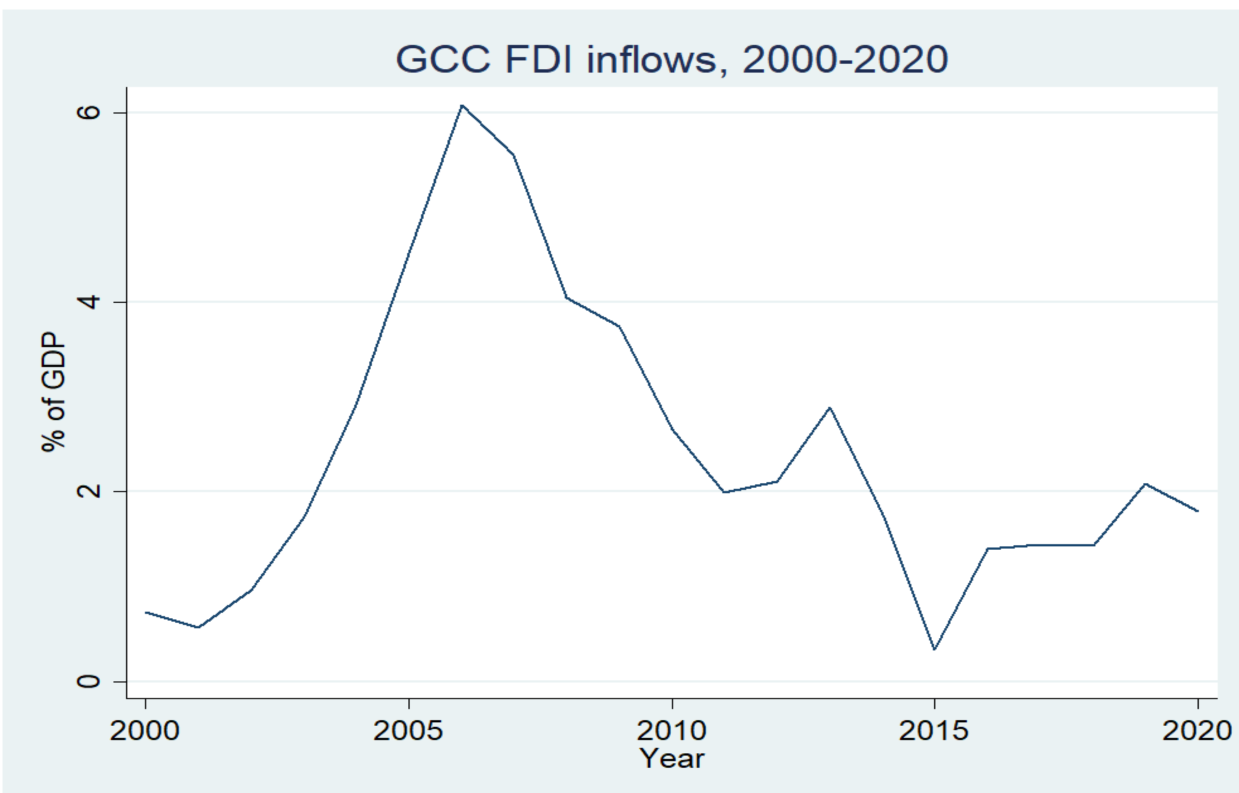
I. Introduction

Private investments and entrepreneurship can support economic growth and generate jobs (Haltiwanger, Jarmin, & Miranda, 2008). The quality of the business environment plays a prominent role in determining the level of private investments and entrepreneurial activity. Klapper and Love (2011) showed that flexible and easy business registration process is associated with more dynamic formal business creation. Likewise, the World Bank suggests a strong negative correlation between the procedures necessary to start business and the number of new firms' registration. In other words, differences in regulatory quality can influence how many new firms are created every year. New businesses are being set up at a faster rate in countries with efficient regulatory environment and less red tape and unnecessary procedures and the opposite is true. The economic literature is abundant with studies that points out the positive impact of improved business regulations on firm creation, economic growth, and employment (Bailey & Thomas, 2017; Branstetter, Lima, Taylor, & Venâncio, 2014; Klapper, Laeven, & Rajan, 2006; Messaoud & Teheni, 2014; Rostam-Afschar, 2014; Van Stel, Storey, & Thurik, 2007).

The Middle East and North Africa (MENA) region has one of the lowest business entry rates across all regions. Firm formation in the GCC economies (The Kingdom of Saudi Arabia, the United Arab Emirates, Kuwait, Bahrain, Oman, and Qatar) is higher than the MENA non-GCC economies, but still relatively low by international comparison (Sahnoun, Keefer, Schiffbauer, Sy, & Hussain, 2014). The GCC countries have long relied on the public sector to employ their citizens and lead economic growth (International Monetary Fund, 2020). On the other hand, the private sector remains much dependent on public spending and mainly relying on expatriates. Considering the demographic reality that exhibited in the increasing share of the young population and the transition to clean energy, encouraging private sector investments should be an economic priority in the GCC economies, as no economy can develop without a healthy private sector. Despite that expatriate population represent the majority of the population in most of the GCC countries, the contribution of expatriates in saving, investment and growth remains limited. This is largely due to the restrictions imposed on overly regulated business environment that may curb innovative entrepreneurs , rigid labor mobility, and length of residency that obscures long-term planning (International Monetary Fund, 2019; World Bank Group, 2019). A recent IMF staff study has shown that foreign investments in the GCC economies are substantially below their potential, due to business regulatory constraints on foreign investors and expatriate entrepreneurs (International Monetary Fund, 2018).

The GCC countries are quite open trade but to less extent when it comes to private foreign investments and entrepreneurship. Despite the policy efforts and reforms that includes improving the governance quality and the adoption of International Financial Reporting Standards, foreign direct investments flows to the GCC region have weakened in recent years as shown in Figure 1 (Siriopoulos, Tsagkanos, Svingou, & Daskalopoulos, 2021). Foreign investments are largely concentrated on real estate, petroleum, and chemicals. The World Bank, and the International Monetary Fund (IMF) have encouraged the GCC countries to move forward with investment-friendly policies abolishing the stricter requirements on ownership of companies for foreign investors outside of free zones and reducing the entry barriers to boost the underperforming FDI (International Monetary Fund, 2018, 2020; Shaukat Khan & Onder, 2018; World Bank Group, 2019)

Figure 1: FDI inflows to GCC



A number of GCC countries have recently introduced important structural reforms and expatriate-friendly policies since 2018 to attract highly-skilled expatriates and increase the flexibility of the labor market and encourage foreign investments and capital accumulation. For example, Saudi Arabia and Qatar have eased restrictions on the movement of expatriate labor increasing the flexibility of the labor market (International Monetary Fund, 2019). Similarly, the UAE recently took a number of regulatory changes. It granted long-term residency to investors and special talents (doctors, scientists, inventors, as well as creative individuals). It relaxes the restrictions on family sponsorship that permits foreigners to sponsor their family members if their salary exceeds a minimum threshold. With the aim of creating a friendly business environment, most of the GCC countries have created special economic zones that are isolated from domestic economies with liberalized regulations that allow for 100 percent foreign ownership of companies, duty-free status, and simplified administrative procedures (International Monetary Fund, 2018). For example, Oman, Kuwait, Bahrain, and the UAE all have created free trade zones. There are around 30 free zones in Dubai alone for various purposes and functions such as higher education, media production, health care, and finance (Dubai Department of Economic Development, 2020). The ownership restrictions on new firm creation outside of special economic zones might represent a barrier to new entrants and entrepreneurs, as it blocks disruptive entrepreneurs from entering the market and generate jobs. In fact, the special economic zones were created as a stepping stone toward a more liberalized economy not an end goal in itself (International Monetary Fund, 2018, 2020; World Bank Group, 2019)

The UAE is well ranked internationally in the ease of doing business and the process of firm formation is digitalized, quick and easy, but the firm ownership rules have been constrained as foreign ownership is not allowed to exceed 49% of the total assets of a company outside the free zones with the majority stake being held by an Emirati partner (Central Bank of the UAE, 2021). These restrictions can make it difficult for entrepreneurs with innovative ideas to enter the market and could negatively affect the economy, as entrepreneurs struggle to meet the ownership requirements. In 2021, the UAE has made a substantial progress in opening its economy to its expatriate entrepreneurs. It introduced amendments to the commercial companies' law in 2021 that permit 100% foreign ownership of UAE-based business without requiring a partnership with a national sponsor. The loosening of the ownership rules aims to increase the competitiveness of the business environment through boosting foreign investors' confidence, open up investment opportunities to expatriates, attract new capital, spur economic diversification and consequently increase employment opportunities in the economy.

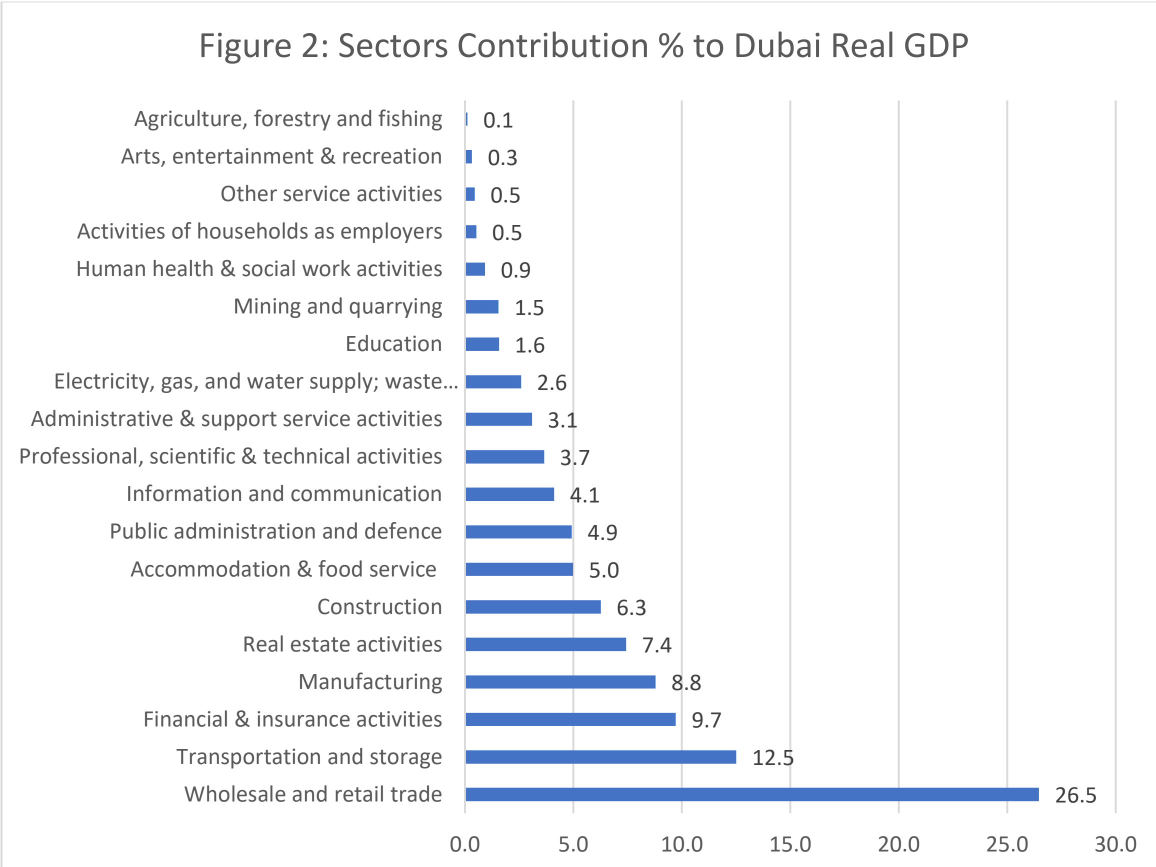
Little is known about the impact of the new relaxed ownership rules on private investments and the number of newly registered firms in the UAE. Given the lack of previous studies on this topic, this study has an important policy implication for the IMF and studying the impact of the improved rules are highly important from a policy point of view for governments in developing countries. The liberalization policy is a cornerstone of the IMF structural adjustment programs that has not been put to test at least in the MENA region. This study fills this gap by contributing to the debate on the impact of liberalization policies on economic activity. The study's findings can provide policy guidance to other GCC countries as well as developing countries considering imposing less requirements on foreign investments and expatriate entrepreneurs.

The study seeks to benefit from the recent regulatory changes by providing early empirical evidence on the short-term consequences of the improved ownership rules in the UAE. There are many potential mechanisms by which the new rules might influence new firm creation and the entrepreneurial activity. The new rules grant greater power to expatriates wanting to start or expand a formal business, who will have now complete control over how to run the business without the need to obtain the approval of the partner. Consequently, reducing the risk of disputes and fostering investors' confidence. The flexible ownership rules also reduce the cost of doing business as some of the partners might be misusing the ownership constraints by extracting rent from business partners without real contribution to the business activity.

In 2016, Bahrain was the first GCC country to introduce full foreign ownership of companies in many sectors. To the best of my knowledge, no previous study has evaluated the causal impact of this policy on business entry rates and foreign investments in Bahrain. However, the flexible ownership regulations seem to improve the country's ranking in the World Bank Ease of Doing Business. We find one study that looks at the impact of the 2011 labor market reforms in the UAE that relaxed labor market restrictions on expatriates workers (Naidu, Nyarko, & Wang, 2014). Before the reform, each migrant worker is tied to one employer during the contract period and at the expiry of the contract, the worker may renew the contract with the initial employer or provide written permission from the initial employer to join another employer. The 2011 reform has abolished the permission required from the previous employer. The findings of the study suggested as labor mobility increases; incumbent migrants' earnings increase, and the firm's retention of the workers also increased. The study supports the hypothesis that less rigid labor market regulations improve the labor market outcome. Therefore, this study represents the first attempt to assess the impact of the regulatory changes on business entry rates in Dubai since it is the main business hub of the region and data have been attained. The paper measures business entry by the number of new business licenses that issued before and after the implementation of the ownership liberalization rules using panel data. The next section provides a background on the economy of Dubai followed by a description of the identification strategy and data. Section IV discusses the results of the study and section V concludes the paper.

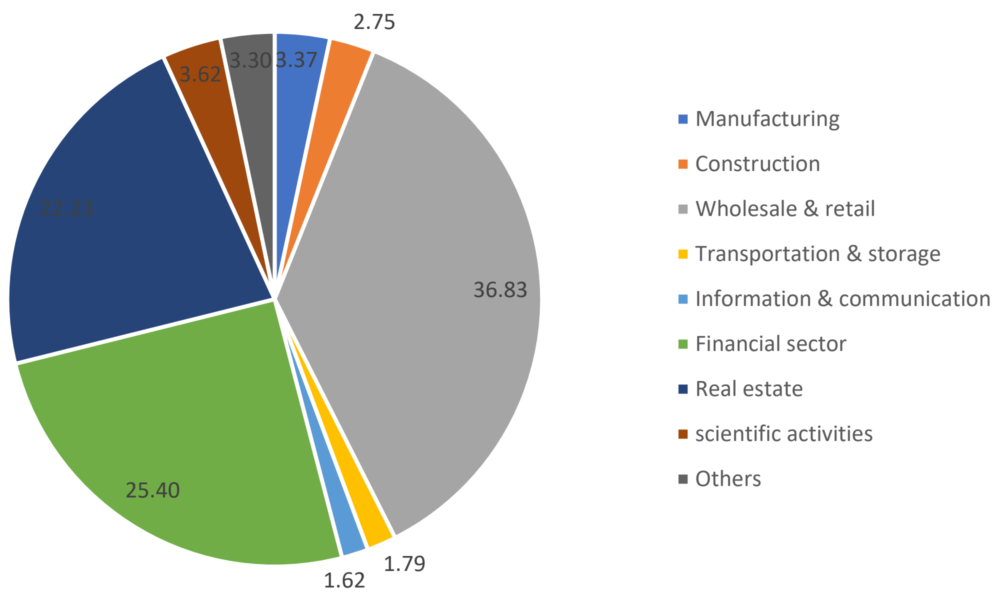
II. Background on Dubai's Economy

This section provides a brief background on Dubai's economy. It is the second biggest economy in the UAE after Abu Dhabi. It is the most diversified and competitive economy in the GCC region. It is the trade hub for the region connecting the Arabian Gulf with India and Africa. It has a strong reliance on foreign trade for economic growth (Dubai Department of Economic Development, 2019, 2020). For example, the value of trade flows (exports, re-exports, and imports) in merchandise trade accounts for over three times its GDP in 2018. The value of Dubai's GDP in 2019, at constant prices, is about US$ 111.4 billion with a population size equal to 3.3 million persons dominated by expatriates (Dubai Statistics Center, 2020a, 2020b; Oxford Business Group, 2019). Looking at the sectoral contribution to Dubai GDP (See Figure 1) would suggest that seven sectors are the main contributors to Dubai GDP representing 76.2% of Dubai's total GDP in 2019. These sectors are the wholesale and retail trade sector, 26.5% of GDP, Transport and storage, 12.5 of GDP, Financial and Insurance activities, 9.7% of GDP, Manufacturing, 8.8% of GDP, Real Estate Activities, 7.4% of GDP, Construction, 6.3% of GDP, Accommodation and food service, 5% of GDP. The structure of Dubai economy clearly reflects the success of Dubai in diversifying its economy away from hydrocarbons. However, oil demand still can affect the external demand for Dubai exports (Al Faris & Soto, 2016).



Attracting high FDI inflows has been an important policy consideration for the Dubai economy. The stock of FDI expressed as % of Dubai GDP reflects the substantial contribution of FDI to Dubai's economy and the degree of its openness. The share of FDI stock as % of GDP topped the advanced economy average, 44% of GDP (United Nations Conference on Trade and Development (UNCTAD), 2018). However, comparing Dubai to Singapore, an economy that shares several characteristics with Dubai such as openness to expatriates, population size, strong infrastructure, and trade hub economy, Singapore's economy enjoys a stock of FDI that is three times its GDP. Figure 3 shows the composition of Dubai's FDI stock across economic sectors. The figure suggests that FDI stock is concentrated in 3 key sectors, wholesale and retail trade, the financial sector, and the real estate sector.

Figure 3: Composition of Dubai FDI stock



III. Data and Identification Strategy

To shift away from fossil fuel and to increase the attractiveness of business environment, the UAE announced in 2018 its intention to allow foreigners to own up to 100 percent of onshore companies, which was restricted to 49 percent. However, the announced changes were not implemented until 2021. In 2021, the UAE Government introduced amendments to the Federal Commercial Companies Law, granting foreign investors 100 percent ownership of several businesses' activities. The 100 percent foreign ownership rules do not require any modifications to license procedures or requirements for business licensing. Also, there is no additional fees, guarantees or capital required for full foreign ownership. The fact that the other factors (procedures, requirements and the cost license) remain constant, facilitates our job in unravelling the causal impact of the liberalization policy without intervention from other factors that may complicate the identification strategy.

The new ownership rules have been applied from 1 June 2021 to 1065 type of business activity (commercial and industrial) except for two types of economic activities. First, economic activities with a strategic impact, which are limited to seven sectors. The seven sectors are: security, defense and military activities; banks, exchange houses and finance companies; insurance; currency printing; communications; Haj and Omra services; Quran centers; and services related to fish traps. In addition to the defined strategic sectors, an additional type of business activities remains untouched by the reform, namely professional activities where it remains necessary for foreign investors wanting to start a business to cooperate with a UAE national at least to meet the judicial formalities. Professional business licenses permit professionals to start a business based on their intellectual or artistic talent. Carpentry, artisanship, consultancy services, printing and publishing, beauty salons, repair services are all example of professional activities that remain unaffected by the new ownership rules. The reason for this exemption is purely legal, as the professional licenses fall under the Civil Transactions Law, while the commercial and industrial licenses fall under the Commercial Companies Law and policy makers decided to start amending the Commercial Companies Law, provided that amendments to the Civil Transactions Law would be extended at later stages. In sum, the flexible ownership rules cover about 40% of different types of economic activities. The variation in in ownership rules across time and types of business activities provides a potential instrument to identify the casual effect of liberalization rules on new firm creation and business entry.

We use difference-in-difference (DiD) approach to estimate the effect of the change in the requirements for registering companies. The DiD is commonly used to evaluate the impact of regulatory policy change (For example, see Card and Krueger (1993)). DiD has been used in similar contexts that looked at the impact of liberalization policies on economic and social outcomes. For example, Galiani, Gertler, and Schargrodsky (2005) questioned whether privatizing the provision of water services improves health outcomes in Argentina. The assessment of the liberalization took advantage of the heterogeneity in ownership status of water local companies across municipalities over time to determine the effect of the privatization on children mortality. They suggested that privatization helps in reducing child mortality by 8%. Similarly, Wahba and Assaad (2017) used DiD to examine whether the introduction of more flexible labor regulations reduces labor informality in Egypt. They suggested that non-contracted employees, who work for the formal sector, where other co-workers are contracted, would be directly affected by the new law (the treatment group). On contrast to the non-contracted workers in the informal sector, where all other co-workers have no job contracts, should not be affected by the introduction of the new law and can be used as a comparison group.

We compare the two period before and after the change in law. We looked at the number of new business licenses across two groups of economic activities: the first group (the treatment group) includes the economic activities that were not allowed for foreign ownership before the change of law and became permitted in June 2021 and the second group (the control group) includes the economic activities that subject to ownership restrictions and remained unaffected even after the change in the Commercial Companies Law. Instead of comparing the number of new licenses for the treatment group and the control group after the policy change, the difference-in-difference method compares trends between the treatment and the control group, and the impact of the law is captured by the difference in those two periods' growth rates.

The new amendments to commercial law allow full ownership of 1,065 commercial and industrial activities out of the 2643 total economic activities. However, the operating business activities are about 1,577 business activity. Within this group, 787 economic activities have been affected by the new ownership rules, whilst 790 economic activities remained unaffected.

The analysis of this study is based on unique data collected from the Business Registration and Licensing Sector at the Dubai Department of Economy and Tourism, Government of Dubai. We construct a balanced panel dataset that includes all the number of the new issued business licenses broken down by the type of business activity. Investors wanting to create a new firm or to expand their existing business must issue a business license from the Business Registration and Licensing Sector.

Our data are monthly date covering the period between February 2021 to October 2021 across all types of economic activities operating in Dubai. The outcome variable is the number of newly issued licenses in Dubai. In total, we have 14,193 (=9 month×1577 economic activity) data points. The new liberalization rules (the intervention) have been effective from June 1st, 2021 and the official announcement of the implementation date was on the 24th of May 2021, that is, about a week before the new rules become effective. Out of 1577 business activities, 787 business activities were affected by the flexible rules and 790 business activities have the same rules.

To unravel the impact of the new policy from other confounding variables, such as business cycle effects, we include a control group. By including a control group, we can rule out the potential effect of the other time-varying factors that may affect the business environment, as both the treatment and the control groups are exposed to the same environmental conditions and the other factors that are likely to affect the number of new licenses over time. On the other hand, comparing the same group to itself (before and after the policy change) controls for the time-invariant factors in that group; therefore, the difference-in-difference will eliminate the source of bias and leave us with the impact of the policy change.

We run a panel-data linear model to evaluate the impact of the liberalization policy on the treated business activity. Our outcome variable is the number of newly issued licenses during the study period. Our model can be presented as follows:

$$\mathrm{Y}_i = \beta_0 + \beta_1 d_1 + \beta_2 T + \beta_3 (d_1 \times T) + \beta_4 trend + + u \quad (2)$$

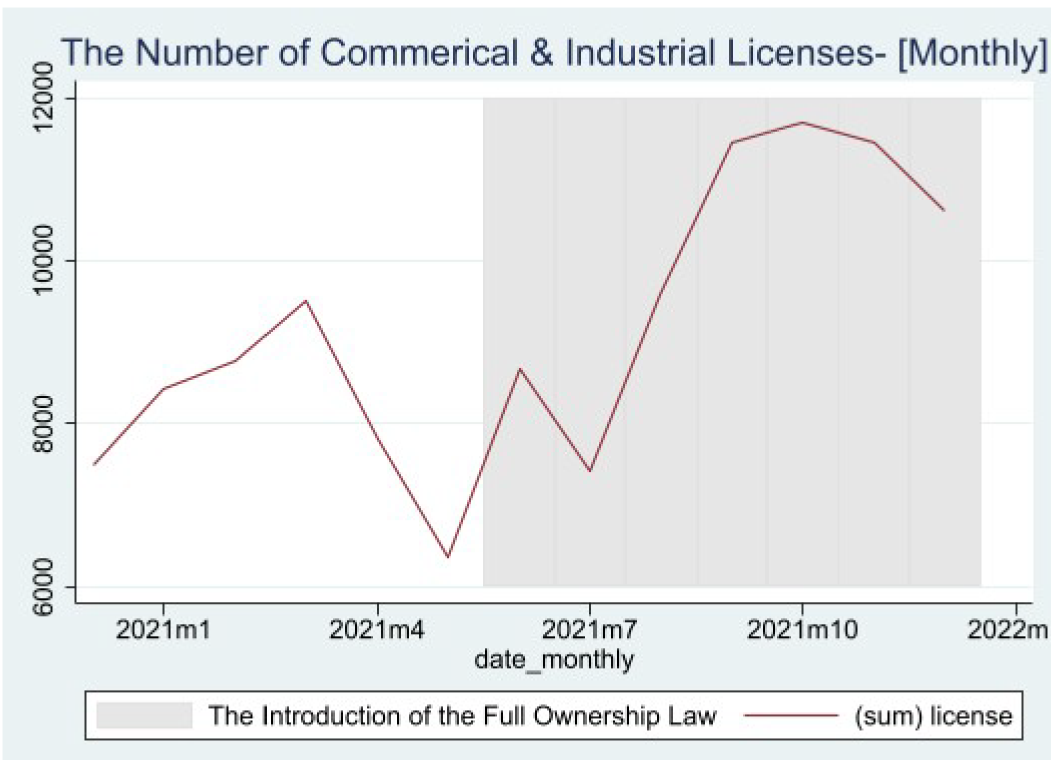
The outcome Y_i (the number of new licenses) is modeled by the above equation. The dummy variable (d1) is an indicator of whether the observation is from before or after the policy change, so it equals one right after the imposition of the new regulations (post-policy change) and zeroes otherwise. Another dummy variable (T) is an indicator of whether a license is affected by the new policy (the treatment group); therefore, it equals one for the treatment group and zeroes for the comparison group. The coefficient of interest is β_3 as it measures the effect of the liberalization policy (the treatment effect). We add a dummy variable for each type of business activity to control for its fixed effect. We also control for the time trend (trend) to control for the secular trend.

IV. Results

Figure 4 demonstrates the trajectory in the overall number of new licenses in Dubai before and after the law. As shown in the figure, the overall number of the new licenses made a significant jump right after the introduction of the new ownership rules. Surely, this surge in the number of new licenses would have favorable impact on public revenue. We cannot attribute the increase in the overall number of licenses to the treatment effect by looking at Figure 4, as we cannot rule out the possibility that other factors contributed to the increase in the number of new licenses. Thus,, we need to compare the treatment group with the control group before and after the intervention to rule other factors.

Figure 5 does that by plotting the means of the number of new licenses over time for the control and treatment group. The figure suggests the control and treatment group were moving in tandem and following a parallel path before the change in the ownership rules, which suggests that the parallel-trend assumption of DiD is satisfied. The linear trend model in the right-side is another way to examine the parallel trend assumption and uses a common time reference point. The chart suggests the two lines are almost the same before the intervention. We can also conduct a test to see if the parallel trend assumption is satisfied by adding variables representing time trends before and after the policy intervention for the two groups of business activities. The linear trends model estimates whether the coefficient for the difference in linear trend before the policy intervention is zero or not the test null hypothesis the linear trends are parallel; thus, if the coefficient is zero, the parallel trends assumption is satisfied. The parallel trend test yields that we do not have enough evidence to reject the null hypothesis (prob > F=0.95) of parallel trend in this case.

Figure 4: The Number of New Issued Licenses



Interestingly, Figure 5 shows a sharp increase in the number of new licenses that affected by the new ownership rules while the control group maintained its trend in the post-intervention period without interruption from the policy change. This pattern may suggest that policy intervention has a role in the big increase in the number of new licenses after the policy change.

Figure 5: Parallel Trends

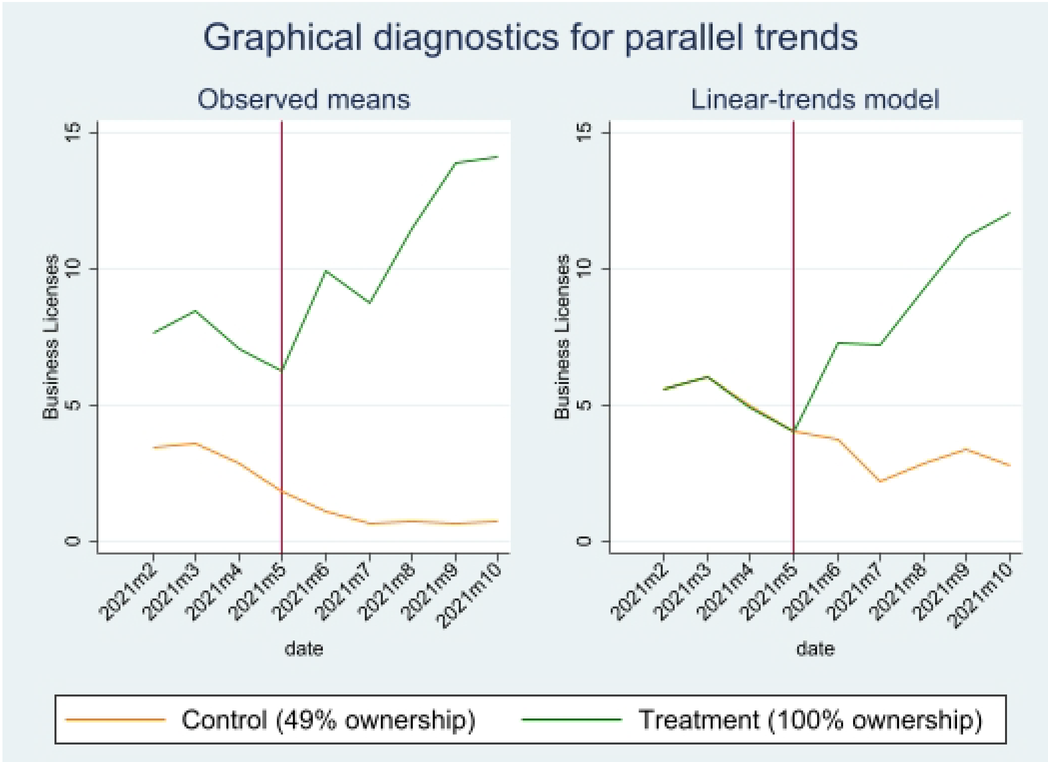


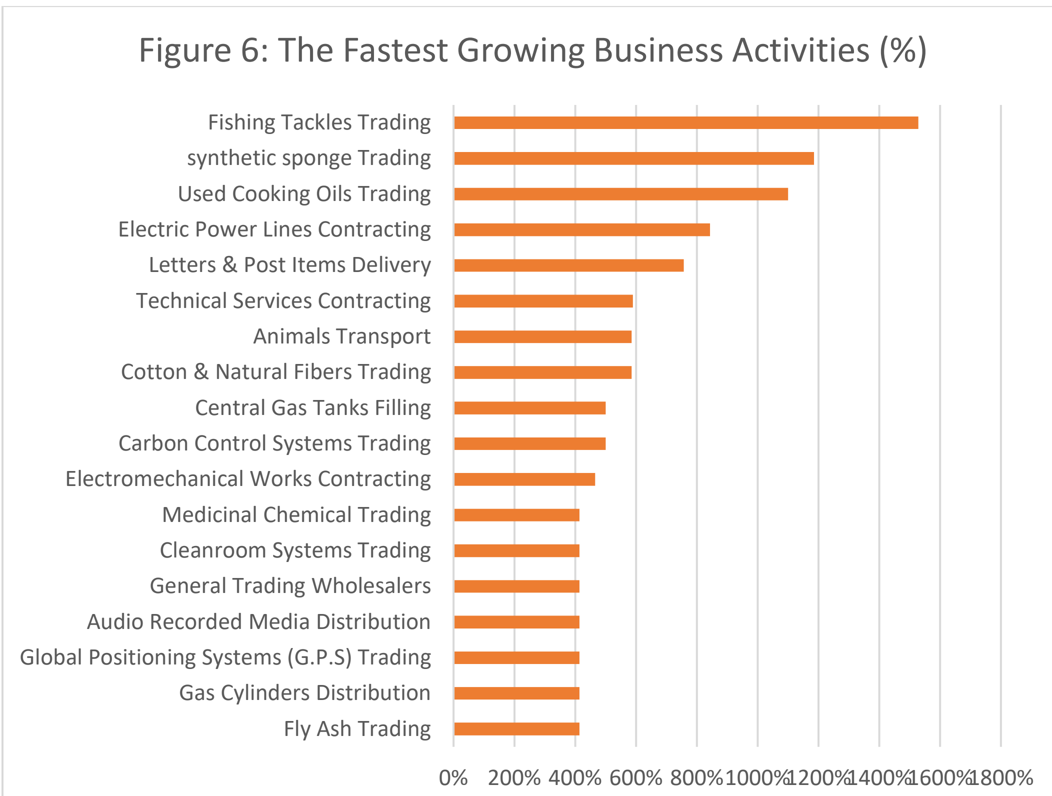
Table 1 shows the regression results for the DiD model stated in the previous section. The estimate of the flexible ownership rules is captured by β_3. β_3 is positive and highly significant at 1% level of significance. It suggests the average monthly number of licenses in the treatment group has increased by additional 6 licenses per month after the flexible regulations compared to the scenario in which the flexible ownership regulations have not been introduced. This is economically significant as the average number of licenses is around 6 licenses across different types of business activities. The new rules have doubled the number of issued business licenses. We used robust standard errors adjusted for 1,577 clusters, i.e., type of business. This supports our hypothesis that flexible regulations had a positive impact on new firm creation and the new rules induces a deviation from the common trend. The results are robust to different model specifications and the new rules effect maintain its positive significant impact on the number of issued licenses.

Table 1: Diff-in-Diff regression results

	Diff-in-Diff
β_3	6.44
Robust std.err	0.53
t-stat	11.98
P>t	0.000
N	14,193

Note: ATET estimate are adjusted for panel effects and time effects.

Figure 6 identifies which type of business activities within the treatment group that surged the most after the introduction of the deregulation of the ownership rules. Trading activities seems to dominate the list.



V. Discussion and Conclusion

Efficient investments and widespread entrepreneurship play a leading role in creating jobs, accelerating economic growth and promoting development. The level of private investment and entrepreneurship in the GCC region are below their potential. The FDI stock (% of GDP) stood under the developed country average except for Bahrain (UNCTAD, 2018). Overlay rigid regulation on firm creation may have detrimental effect, such as less investments, lower job creation, and may deny disruptive investors from entering the market. The GCC countries have taken steps to open their economies with several business reform measures such as establishing special economic zones, reducing red-tape procedures, and digitalizing government procedures. The IMF recommended more flexible regulations on foreign investments to improve the business environment in the GCC countries. In 2021, the United Arab Emirates has deregulated the ownership rules for more than 1,000 commercial and industrial activities allowing full ownership for foreign investors. The introduction of more flexible regulations should encourage the expatriate population, which constitutes the majority of the UAE residents, to accept a more entrepreneurial attitude toward investing in the UAE economy. A few recent studies have explored the impact of flexible ownership regulation in emerging economies, allowing foreigners to own 100% of companies in the UAE. This study represents the first attempt to assess the impact of liberalization of business ownership rules on business activity in the GCC countries. The study fills an important gap in the economic literature. Starting June 1st, 2021, The UAE has permitted 100% foreign ownership of businesses on the mainland. This business structural reform policy is one of the cornerstone policies in the economic diversification programs. The change in the ownership rules provide us with a natural experiment to evaluate the impact of this policy on the level of private investments measured by the number of the new issued business licenses in Dubai. We focus on Dubai, as it represents the region business hub.

To identify the causal impact of the deregulation policy, we took the advantage of exempting some business activities from flexible regulations to serve as a comparison group and control for other factors that may affect the business environment. We adopt DiD approach, where we look for control and treatment groups to evaluate the policy change. our DiD model yields that the liberalization policy led to a substantial increase in the number of new licenses right after the implementation of the new ownership rules.

There are several possible explanations for the positive impact of the policy on private investments proxied by the surge in business licenses. The improved ownership rules have addressed the needs of the expatriate population and support their entrepreneurial ambitions and increase the autonomy over running business and may have attracted new investors from outside of the UAE. For example, several investors flee Hong Kong and China under the pressure of Zero-Covid policy to other Asian destinations such as Singapore and Dubai and the new ownership rules may have played a role. The new rules could also reduce the cost of doing business and reduce the risk of dispute between partners and provide more incentives for entrepreneurship. The recent increase in the number of new business licenses has been associated with a surge in new business growth and employment opportunities across the Dubai non-oil economy as measured by the S&P Global Dubai Purchasing Manger Index (PMI) over the year 2021. The surge in the business licenses will be also translated into higher public revenue. We conclude that our early evidence on the short-term consequences of the liberalization of business ownership rules had a positive impact on the level of private investments, which supports the hypothesis that more flexible regulations on firm formation increases private investments and entrepreneurial activity.

Future studies can explore the long-term consequences of new ownership rules and whether the effect of the liberalization policy is a transitory one. Future studies also can also explore the effect of the reform policy on the productivity of firms and economic growth. One limitation in this study is we look at the number of new licenses but we did not have date on the value of investments associated with the new licenses. However, we can safely conclude the relaxed ownership rules have increased the blood circulation and the heart rate of the business activity is beating faster.

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